National Grain and Feed Associaton

FOCUS on Industry Issues

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# A Primer on Bankruptcy Proceedings ...A Closer Look at the VeraSun Case...

*[**Editor's Note:** This is the second in a two-part series on bankruptcy proceedings. In this edition, the NGFA has solicited the expertise of **Christopher Giaimo**[1], a bankruptcy attorney with the NGFA's outside law firm, Arent Fox, Washington, D.C., to respond to several questions posed by NGFA members in response to the VeraSun bankruptcy filing. His analysis is based upon information available as of Dec. 1. However, most of the information and principles cited in this article are relevant to all bankruptcy proceedings.*

*Part 1 of this series, published Nov. 20, provided information to members concerning the bankruptcy process and the authority of the bankruptcy court to restructure existing contractual arrangements between companies filing for bankruptcy and their suppliers. The bankruptcy process is highly complex, involving an extensive body of detailed laws, rules and procedures. The NGFA does not provide legal assistance or advice in this capacity, and the information provided in this two-part series does not represent legal advice or NGFA's views on any current, pending or future bankruptcy matter. Those individuals or companies involved (or potentially becoming involved) in a bankruptcy case should consult competent legal counsel.]*

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***Q1. First, please clarify the general nature of VeraSun's bankruptcy filing?***

**A:** On Oct. 31, 2008, VeraSun Energy Corp. and 24 of its subsidiaries and affiliates (collectively, "VeraSun" or the "debtors") filed voluntary petitions for relief under Chapter 11 of the U.S. Bankruptcy Code (the "Code") in the U.S. Bankruptcy Court for the District of Delaware. A Chapter 11 filing is designed to provide for reorganization of the debtor. That differs from a Chapter 7 bankruptcy, which among other things, involves a liquidation and distribution of the debtor's assets.

In its bankruptcy filing, VeraSun asserts that its Chapter 11 filing resulted from sizeable fluctuations in the price of corn, natural gas and ethanol, coupled with its obligations to service its debt in the face of continued lack of liquidity in the credit markets and the inability to raise additional investment capital from depressed equity markets. VeraSun lists consolidated assets of approximately $3.4 billion and estimated consolidated debt of $1.9 billion, which includes $450 million of unsecured debt and $210 million of secured debt.

***Q2. What happens to those assets upon the bankruptcy filing?***

**A:** At the time a bankruptcy petition is filed, a bankruptcy estate is created. A bankruptcy estate consists of all legal and equitable interests of the debtor, wherever located on the date of the bankruptcy filing. The Code sets forth the rules governing which of the debtor's interests become property of the estate. The meaning of the term "property" is interpreted broadly, and encompasses all kinds of property, including tangible and intangible property. Because of the breadth afforded the definition of "property," it is well settled that "executory contracts" constitute property of the estate.

***Q3. What was the significance of the Dec. 2 hearing being conducted by the bankruptcy court in Delaware?***

**A:** This was a meeting of creditors conducted by the Office of the U.S. Trustee that routinely occurs within about 30 days after a bankruptcy filing. It allows creditors and the U.S. Trustee to question the debtor – in this case, VeraSun – under oath about the debtor's bankruptcy petition and related filings and to discuss, in general terms, the debtor's plans for reorganization.

***Q4. Next, let's discuss contractual arrangements between buyers and sellers and how they are treated differently under bankruptcy proceedings. Bankruptcy law uses the term "executory contracts." What does that term mean?***

**A:** Under bankruptcy law, an executory contract is one under which performance remains outstanding on the part of both parties to the contract, and failure to perform those obligations would result in a material breach of the contract. This is true notwithstanding any provision to the contrary that exists within such contracts, or applicable law. In this situation, a supply contract between a grain

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supplier – be it a producer or grain elevator – and VeraSun likely would constitute an "executory contract" if both parties have outstanding obligations under the contract and the failure to perform these obligations would result in a material breach of the contract.

Concluding that something is property of the bankruptcy estate is meaningful, since as soon as a bankruptcy petition is filed, an automatic stay goes into effect that prevents all persons or entities from taking any action that would affect such property. This is designed to give the debtor a "breathing spell" to try to rehabilitate its business. Because executory contracts are property of the estate, the automatic stay prevents the non-debtor party from terminating or adversely affecting the debtor's rights under the contract.

***Q5. Are all executory contracts treated the same in bankruptcy?***

**A:** No. Section 556 of the Code also recognizes "commodity" and "future" contracts for which special protections are granted to the non-debtor party. These types of contracts were added to the Code to minimize disruption in the commodities and futures markets by allowing prompt liquidation of an open market position. We'll discuss these types of contracts and the protections involved in more detail starting in Question 10.

***Q6. Let's take a closer look at executory contracts. How are such contracts treated in the proceedings that occur following the filing of a bankruptcy petition?***

**A:** A debtor in bankruptcy – in this case, VeraSun – has a fiduciary duty to maximize the value of its estate. Consistent with that purpose, the law grants a debtor certain powers with respect to executory contracts. Specifically, a debtor is granted authority to determine which contracts add value to the estate. If a debtor determines that a contract is valuable, the debtor can "assume" the contract and performance will continue. On the other hand, if the debtor determines that a contract is a liability, it can be rejected and thus terminated. Importantly, a debtor must assume or reject a contract in its entirety; it cannot select certain provisions to assume and others to reject.

The debtor's decision to assume or reject a contract is subject to approval by the bankruptcy court, which will apply a "business judgment" test when evaluating a debtor's decision. Generally, the "business judgment" test applied by the bankruptcy court requires a debtor to show it has a sound business reason for either rejecting or assuming a certain agreement. Rejection of a contract relieves the debtor of its obligations to perform under the contract and causes the forfeiture of any future benefits therefrom. Accordingly, rejection constitutes a breach by the debtor as of the date the bankruptcy case was filed. A rejection entitles the non-debtor party – for example, a supplier that had a contract with VeraSun – to a general unsecured claim for damages for breach of the agreement.

Conversely, if the debtor assumes the contract, the debtor is bound by its terms and any liability under the contract going forward. If a debtor assumes an executory contract, it also has the latitude to assign that contract to a third party for value. Bankruptcy law favors assignment. Therefore, express contractual clauses that seek to prohibit assignment of a contract, as well as clauses that otherwise attempt to limit assignment, are unenforceable under bankruptcy law.

In addition, before a debtor may assume an executory contract, the debtor must cure any default under the contract, or at least provide "adequate assurance" for prompt cure of existing defaults. Thus, upon assumption of a contract by VeraSun, the party with the contract will be paid in full the outstanding unpaid amounts under the contract. This treatment is unlike other pre-petition creditors.

***Q7. Is there a specific deadline for a debtor to decide whether to assume or reject executory contracts?***

**A:** The Code does not set a firm deadline for a Chapter 11 debtor to make a decision to assume or reject most executory contracts. A debtor is granted a great deal of time – until confirmation of a plan of reorganization – within which to decide to assume or reject executory contracts. However, as discussed subsequently in this article, a non-debtor party may request that the court set an earlier deadline based upon compelling circumstances.

***Q8. What are the parties' obligations under an executory contract prior to the time the debtor decides to assume or reject it?***

**A:** The U.S. Supreme Court has ruled that a non-debtor party cannot enforce a contractual provision of an executory contract against a debtor unless the debtor has assumed the contract under the Code *[NLRB v. Bildisco & Bildisco, 465 U.S. 573 (1984)]*. Because the non-debtor party cannot enforce contractual provisions against the debtor, a non-debtor party therefore may not terminate a contract based upon the debtor's failure to comply with a contractual provision. Any such acts may constitute a violation of the automatic stay issued by the bankruptcy court. Accordingly, during the period from the date the debtor filed for bankruptcy until the date the debtor assumes or rejects the contract, the non-debtor party legally is required to perform its obligations under the executory contract, even though the debtor is excused from such performance.

***Q9. Can you quickly summarize the principles applying to an executory contract that have been discussed thus far?***

**A:** Certainly. First, a debtor in a bankruptcy case generally is not bound by an executory contract unless and until that contract is formally "assumed." Second, a non-debtor party generally is required to perform under an executory contract during this period. Third, a non-debtor party may not unilaterally terminate an executory contract on grounds that the debtor is in default for failing to pay an outstanding amount owed by the debtor before it filed for bankruptcy. And finally, after the filing of a bankruptcy petition, a non-debtor party may not terminate an executory contract when the termination is based upon an action or inaction of the debtor that would justify termination if the debtor was not in bankruptcy.

Under the preceding analysis, if a grain supplier and VeraSun are parties to an executory contract, the supplier may not terminate such a contract legally unless it obtains an order from the court granting relief from the automatic stay. Likewise, the supplier would not be entitled to assert any state law remedies based upon VeraSun's failure to perform under the contract. Further, the supplier would be required to continue to perform under an executory contract. VeraSun, however, may not necessarily be required to continue to perform pending the decision to assume or reject the contract.

***Q10. Do any remedies exist for a non-debtor party involved in an executory contract?***

**A:** Yes. There are several remedies available that can be pursued by a non-debtor party during the period between the time the bankruptcy petition is filed and the time the executory contract is assumed or rejected. However, to obtain these remedies, the non-debtor party is required to file a motion with the bankruptcy court and obtain an order granting permission to pursue these remedies.

One such motion would be to <u>request that the court order the debtor to decide within a specified period of time whether to assume or reject the contract</u>. A "specified period of time" generally has been construed to mean a "reasonable time" as determined by the court. Courts will look to the equities involved in making such a determination. However, the court's overriding consideration is to protect the debtor and to allow for the debtor's financial rehabilitation. This means the debtor, in the absence of compelling reasons, almost always is given a very significant period of time during which it may decide whether to assume or reject an executory contract.

Second, if a debtor in bankruptcy continues to receive the benefits of an executory contract from a non-debtor party before it decides whether to assume or reject the contract, the debtor is obligated to pay for the reasonable value derived from the contract. In these circumstances, the <u>non-debtor party is entitled to an administrative claim</u> (a priority claim against a debtor that arises from a creditor providing necessary and beneficial services and/or goods after the bankruptcy case is filed) <u>for the value of the goods or services provided during the period between the filing of the bankruptcy petition and the decision whether to assume or to reject the contract</u>. A non-debtor party can file a motion to require the debtor to immediately pay such claims. Administrative claims are entitled to priority and, unlike general unsecured claims, generally are paid in full.

Further, as discussed previously, if the debtor is in material breach of the executory contract, the non-debtor may file a <u>motion for relief from the automatic stay to effectuate a termination of the contract</u>. The basis of such a motion would be that the non-debtor party is being inequitably harmed by the existence of such breach. Again, the court will consider the equities when analyzing whether to grant this relief.

Finally, as set forth previously, before a debtor may assume an executory contract, it must <u>cure all defaults or provide adequate assurance that it will do so</u>. For all practical purposes, the debtor may not assume a contract unless the non-debtor party is made whole.

To emphasize some pertinent considerations:

- **<u>A Non-Debtor Party May Not Legally Terminate An Executory Contract Without Obtaining the Bankruptcy Court's Permission to Do So</u>:** Particularly when a contract is considered to be an executory contract, within the meaning of the Code, the law prohibits the non-debtor party from unilaterally terminating such a contract. Therefore, as an initial matter, grain suppliers that have an executory contract with VeraSun, absent an appropriate Court order, are advised <u>not</u> to terminate such contract or take any other formal actions that could be construed as enforcing the contract or pursuing state law remedies, if available, against VeraSun. Such actions may result in either a breach of contract or a violation of the automatic stay imposed by the Code.
- **<u>A Non-Debtor Party May Negotiate for Contractual Modification with the Debtor</u>:** Nothing in the Code prohibits negotiations with a debtor. Accordingly, regular business discussions should not create a concern about possible violation of the automatic stay. If, however, during such discussions the non-debtor party were to press legal arguments that could be construed as enforcing remedies, a debtor could claim that such exertion of pressure violates the automatic stay. Consequently, a non-debtor party, such as a grain supplier, should be careful about how it conducts its business discussions with the debtor.

***Q11. Let's turn to commodity contracts, which you briefly referenced in question #4. What kind of contracts are these under bankruptcy law?***

**A:** Section 556 of the Code confers special protections on parties that have entered into "commodity contracts." The term "commodity contract," as it is used in the Bankruptcy Code, encompasses agreements for purchase and sale of commodities for future delivery on, or subject to rules of, a contract market or board of trade, and leverage transactions. Section 556 provides that if a commodity contract authorizes a broker or forward contract merchant to liquidate, terminate, or accelerate a commodity contract because a debtor is insolvent, bankruptcy law will not prevent the exercise of such right. The term "commodity contract" is broadly defined in the Code, and encompasses purchases and sales for future delivery on, or subject to the rules of, a contract market or board of trade and leverage transaction. The 2005 amendments to the Code added further language to the definition of "commodity contract" to clarify the inclusion of similar agreements and related master agreements, security agreements, guarantees, other credit enhancement arrangements and options. Whether a particular grain supply or other contract falls within the definition of a commodity contract under the Code would require review of the specific contract itself.

***Q12. What kind of additional protections are afforded to commodity and future contracts under bankruptcy law?***

**A:** There are two principal features of the Code that provide additional protections to non-bankrupt parties that have entered into commodity or future contracts with a party that has filed for bankruptcy:

- **<u>Termination, Liquidation or Acceleration Protection With Regard to Commodity Contracts</u>**: Many executory contracts contain provisions that provide for a default if one of parties to the contract becomes insolvent or files for bankruptcy. As a general rule, these provisions (called "*ipso facto* clauses") are not enforceable. Accordingly, such provisions are generally meaningless in ordinary executory contracts. However, the section 556 of the Code specifically allows non-debtor parties to commodity and future contracts to enforce such provisions. Accordingly, a non-debtor party to a commodity or future contract generally is permitted to close out or liquidate its position upon the other party's filing for bankruptcy. These actions typically entail termination or cancellation of the contract and a setting off of the damages suffered by the non-defaulting party, based upon market conditions at the time of the liquidation. Generally, the non-debtor party's rights to liquidate, terminate or accelerate the commodity and future contracts are derived from written agreements or other documents governing the securities transaction, as well as market customs and usage, exchange rules or clearing corporation rules, rules or bylaws of national securities exchange, a national securities association, or other securities clearing agency. Section 556 of the Code does not independently provide such rights; but of course, it also does not prevent the non-defaulting party from exercising them and neither does the automatic stay provision.

- **Effects of the Automatic Stay on Commodity Contract**: Because section 556 of the Code allows non-debtor parties to commodity and future contracts to terminate and liquidate such contracts based on the debtor's filing for bankruptcy, such actions do not constitute violations of the automatic stay as they would with ordinary executory contracts. Furthermore, section 362(b)(6) of the Code specifically permits a protected non-debtor party from exercising its rights to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with the commodity or future contract.

***Q13. Is there a deadline for parties that have entered into executory or commodity contracts to file a petition with the bankruptcy court seeking remedies?***

**A:** Maybe. There are precious few reported judicial opinions on the extent of the remedies a non-debtor to a commodity or future contract may enforce if the other party files for bankruptcy. However, it is clear from the Code that non-debtor parties have the right to terminate, accelerate and liquidate such contracts based solely upon the debtor's filing for bankruptcy. Accordingly, it is unclear whether termination for any other reason is protected. Therefore, the timing of the termination may be an issue because there may be an appearance that a termination that occurs a long time after the debtor's filing for bankruptcy (i.e., more than a year) may have been precipitated by reasons other than the bankruptcy filing. If the court finds that the termination is for a reason other than the debtor's bankruptcy filing, such termination may not be protected by the Code and constitute a violation of the automatic stay. Thus, the closer in time to the bankruptcy filing the termination occurs, the more likely it will withstand scrutiny from the bankruptcy court.

***Q14. Can a non-debtor party determine if it has entered into an executory contract, or whether the contract can be interpreted to be a commodity or future contract that is eligible for more preferential treatment under bankruptcy proceedings?***

**A:** Determining if a contract constitutes a commodity or future contract can be very complex, requiring a thorough analysis. It is recommended that non-debtor parties seek advice from competent legal counsel who has expertise in bankruptcy law, which is a very specialized field of law. Bankruptcy legal counsel can review the specific contracts in question and make a determination.

***Q15. Finally, let's look at claims vendors may have against parties that have filed for bankruptcy. What is a "vendor claim," and how might that be relevant in the VeraSun case?***

**A:** On Nov. 1, VeraSun filed a motion with the court seeking approval of procedures whereby certain vendors delivering certain goods, such as corn and other high-starch grains, chemical substances, denaturants and natural gas, would be paid for such goods that were delivered within 20 days of the petition filing date. VeraSun's motion asked the court to consider such payments as an administrative claim. VeraSun also sought court authority to continue payment to such vendors that provide goods during the course of the bankruptcy case as an administrative claim.

On Nov. 4, the court granted VeraSun's motion. The fact that the court granted this motion is not unusual. In fact, it's relatively standard. Absent such a court order, VeraSun would not have been permitted to pay for any of the grain or other transactions it had entered into during the time period specified in the court order. Debtors in bankruptcy proceedings are not permitted to pay on amounts arising under contracts that precede the filing of the bankruptcy proceeding without such orders being issued by a bankruptcy court.

The court's order permits, but does not require, VeraSun to make payment to such vendors that: 1) delivered goods within 20 days of the petition date and the bankruptcy filing; and 2) continue to deliver goods after the petition date. This court order also contains provisions providing that any vendor that receives and deposits such a payment agrees to continue to provide goods to VeraSun at prevailing market prices in accordance with the most favorable terms and conditions that historically have existed between such a vendor and VeraSun. Finally, any such payments to be made to these vendors are subject to VeraSun having sufficient funds and being authorized under its post-bankruptcy loan facility. Here again, determining whether this order affects a particular grain supplier or contract would require a review of the specific contracts and any documents evidencing delivery of goods to VeraSun.

## Conclusion

In sum, a party to a standard executory contract (i.e., not a commodity contract) with VeraSun may not unilaterally terminate such a contract without great legal risk of violating the bankruptcy code. Negotiating possible modifications of an executory contract may give the non-debtor party that has entered into an executory contract the possibility to obtain assurance for future performance from VeraSun.

Contrary to a standard executory contract, a non-debtor party to a commodity contract is given much greater protections under the Code. Non-defaulting parties under this type of contract may exercise certain contractual rights to, inter alia, terminate, liquidate or accelerate without the risk of being in violation of the automatic stay.